

**Minutes
Investment Advisory Council
May 20, 2014**

The Investment Advisory Council (IAC) met at 12:00 P.M. Tuesday May 20, 2014 in the Board Room – First Floor, 60 Empire Drive, St. Paul, Minnesota.

MEMBERS PRESENT: Denise Anderson, Jeff Bailey, Dave Bergstrom, Kerry Brick, Doug Gorence, Dennis Duerst, Kim Faust, Laurie Hacking, Kristin Hanson (for Jim Schowalter), Jay Kiedrowski, Gary Martin, Malcolm McDonald, and Elaine Voss.

MEMBERS ABSENT: John Bohan and Mary Vanek.

SBI STAFF: Mansco Perry, Jim Heidelberg, LeaAnn Stagg, Patricia Ammann, Tammy Brusehaver, Stephanie Gleeson, Aaron Griga, Ryan Hill, J.J. Kirby, Steve Kuettel, Mike Menssen, Charlene Olson and Melissa Mader.

OTHERS ATTENDING: Ann Posey, Callan Associates Inc.; Bert Black, Celeste Grant, Christie Eller, Cumah Blake and Joe Sathe, Office of the Governor; Edgar Hernandez, SEIU; Charles Hellie and John Fisher, REAM; Linda Littrell, Retiree; Emily Moore, Retiree; Mary Palmer, State Retiree; and Gordon Voss.

The minutes of the February 18, 2014 meeting were approved.

Executive Director's Report

Mr. Perry, Executive Director, referred members to Tab A of the meeting materials. He reported that the Combined Funds had outperformed its Composite Index over the ten-year period ending March 31, 2014 (Combined Funds 8.0% vs. Composite 7.7%) and had provided a real rate of return over the latest 20-year period (Combined Funds 8.8% vs. CPI 2.4%).

Mr. Perry said that the Combined Funds' assets increased 1.1% for the quarter ending March 31, 2014 due to positive market performance. He said the asset mix was on target, and he stated that the Combined Funds matched its Composite Index for the quarter (Combined Funds 2.1% vs. Composite 2.1%), and outperformed for the year (Combined Funds 15.6% vs. 14.3%) and over longer periods.

Mr. Perry reported that the domestic stock manager group outperformed its target for the quarter (Domestic Stocks 2.1% vs. Target 2.0%), for the year (Domestic Stocks 24.1% vs. Target 22.6%) and most remaining time periods. He said the international stock manager group underperformed its target for the quarter (International Stocks 0.2% vs. Target 0.5%) but outperformed for the year (International Stocks 13.4% vs. Target 12.3%) and all remaining time periods. Mr. Perry stated the bond segment outperformed its target for the quarter (Bonds 2.0%

vs. Target 1.8%), for the year (Bonds 0.5% vs. Target -0.1%) and all remaining periods. He concluded his report with the comment that, as of March 31, 2014, the SBI was responsible for close to \$75 billion in assets under management.

Mr. Perry referred members to Tab B of the meeting materials for a legislative update. Mr. Perry began with the Omnibus Pension Bill, which he noted was awaiting the Governor's signature. Mr. Perry stated that the first item of interest in the Omnibus Pension bill would give greater investment option flexibility within the various state defined contribution plans as well as the SBI's Supplemental Investment Fund.

The second item in the Omnibus Pension Bill that Mr. Perry noted was the merger of Duluth Teachers Retirement Fund Association into the Teachers Retirement Association. He stated that if the merger takes place, the assets from Duluth would be transferred to the SBI by calendar year end. Mr. Brick requested clarification on the quantity of assets being transferred, and Mr. Perry replied that it was roughly \$200M. Mr. Bailey asked if there were any concerns regarding the quality of assets being transferred? Mr. Perry replied that most of the assets in the Duluth plan were in commingled funds and would be converted to cash before transfer. He additionally noted that counsel would review the private equity funds prior to transfer.

Next, Mr. Perry discussed the Women's Economic Security Act, (WESA) which he noted had been signed by the governor. He stated that the SBI sought and received an exemption from the pay equity certificate requirement of WESA for its Deferred Compensation Plan investment manager contracts. He noted that all other SBI contracts would need to comply with this requirement going forward. Mr. Perry stated that WESA also required that a study on the potential development of a state administered retirement savings plan be completed by Minnesota Management and Budget (MMB). The goal of such a savings plan would be to provide a retirement savings vehicle for employees in the state of Minnesota who had limited access to traditional savings methods. He noted that the SBI would work with MMB on the investment component of this study.

Lastly, Mr. Perry shared that the SBI worked with the State Auditor's Office on a bill to enhance statewide OPEB reporting to the State Auditor's Office. He concluded Tab B by referring members to the budget and other items including the Iran and Sudan updates.

Mr. Perry referred members to Tab C of the meeting materials for an overview of the SBI Administrative Committee report to the Board of the SBI's annual Management and Budget Plan for fiscal year 2015. First, Mr. Perry noted that the majority of the work plan items in Sections B through E were of a recurring nature and he would not review them at this time. Mr. Perry reviewed the new work plan items under Section A, Development of Investment Policies. He first discussed the review of transition managers, which he anticipated would be completed by the end of the first quarter. He then introduced the more comprehensive reviews of both the fixed income and public equity investment structures and noted that they would begin mid-year but likely spill over into the following year. He noted that staff would complete a review of liquid alternative investment strategies such as master limited partnerships, public REITS and commodities, some of which could fit in the defined contribution plans as well as the combined funds. Mr. Perry stated that the SBI staff would research various risk management approaches

used by different organizations and determine which might be most appropriate for the SBI. He then commented that the swaps discussion was a holdover from the last work plan and that until regulators finished their work, no further action regarding their use could be taken by the SBI. Lastly, Mr. Perry shared that the SBI would be working with MSRS to review the investment structures of various defined contribution plans that the MSRS administers with the goal of providing recommendations for investment changes. A discussion followed regarding the IAC's guidance on SBI's investment policies and the best format for the IAC to provide the most constructive feedback. The conclusion was that, for now, members would be contacted individually for their ideas.

Ms. Hacking and Mr. Perry then reviewed the fiscal year 2015 administrative budget request that would be going to the Board for approval. Ms. Hacking stated that the budget proposal included funding for five additional SBI staff and she noted that a previous independent review had concluded that the SBI was relatively understaffed. Mr. Perry stated that two of the new staff would be assigned to alternatives, one to public markets, and two to accounting. After a brief discussion, Mr. Bergstrom moved the passage of the workplan and budget proposals, and Mr. McDonald seconded the motion. The motion passed. Mr. Perry stated that the Fiduciary Education Plan and the SBI Executive Director's Performance Evaluation Process would additionally be taken to the Board.

Mr. Perry then referred members to Tab E containing the recommendation to terminate Turner Investments LP. He reviewed the rationale for termination, which included significant under performance and high portfolio manager and analyst turnover. He stated that although the assets had already been withdrawn, the SBI needed a motion to approve the termination of Turner. Mr. Duerst moved approval of the motion, and Ms. Faust seconded. The motion passed. Mr. Bailey then asked about the replacement process for the terminated investment manager. Mr. Perry commented that although staff may search for a replacement in the future, the Turner assets were converted to cash and used for needed plan withdrawals.

Referring members to Tab F, Mr. Kirby and Mr. Hill reviewed the SBI's alternative investment portfolio. They focused the presentation on the relative sizes of the four sub-categories of alternatives - Private Equity, Real Estate, Resource and Yield-Oriented - and the \$4.4 billion of market value difference between current and target level for alternative investments, otherwise called "dry powder." Mr. Kirby explained the historical reasons for the "dry powder." Mr. Kirby and Mr. Hill then summarized the two new investment commitments. In lieu of guest presentations from private equity managers, Mr. Kirby and Mr. Hill discussed staffs' due diligence process and responded to IAC questions. The first recommendation was a \$125 million commitment to Banc Fund IX, L.P., an existing manager in the financial services buyout space. The second was a \$200 million commitment to Merit Energy Partners I, L.P., an existing manager in the oil and gas buyout space. The discussion of staff's due diligence process was well received by the IAC members. Ms. Voss moved approval of the two new commitments and Mr. McDonald seconded. The motion passed.

Mr. Perry referred members to Tab G for a follow-up discussion of the unallocated portion of alternative investments. He reviewed how the SBI had directed the unused funds to either stocks or bonds historically, and noted that when the Basics and the Post Fund were combined the

policy, in the context of a strategic asset allocation, had been made to put it all in bonds. A lengthy discussion followed. Mr. Perry noted and Mr. Bailey concurred that any change in how the unallocated portion of the alternative investments was directed would most appropriately be dealt with in the context of a strategic asset allocation review.

Mr. Perry briefly discussed that formatting and delivery enhancements to the IAC books would be made in the future.

The meeting adjourned at 2:06 P.M.

Respectfully submitted,

A handwritten signature in blue ink that reads "Mansco Perry III". The signature is written in a cursive, flowing style with a long horizontal line extending from the end.

Mansco Perry III
Executive Director